

# ***Chapter 6***

## ***Overhead Costs***

This chapter discusses:

- Overhead Costs
- The Development of an Overhead Schedule
- Costs Normally Included in a Firm's Overhead
- Unallowable Costs Included in Overhead
- Costs Which Create the Most Confusion for Consultants

### **Overhead Costs in General**

Overhead costs are those general expenses incurred during the normal course of operating a business. At times, these costs may be called General and Administrative, Fringe Benefit Costs, Overhead, or Payroll burden.

The majority of firms doing business with WSDOT lump these business costs together into a firm wide overhead rate. For management purposes, larger firms may segregate the costs into the groups as previously identified. The reasons for this distinction vary; therefore, we reference you to the nearest library or cost accounting textbook. The primary reason is for the management of business costs at the lowest level possible.

WSDOT Auditors use the Federal Acquisition Regulations (FARs) to assist in establishing overhead costs which may be recovered in a firm's overhead rate.

**Note:** We said may be recovered!

The reader needs to understand the distinction between overhead costs and overhead cost categories that can be included in an overhead rate.

This includes the fact that costs accepted by the Internal Revenue Service may not be acceptable for contracting purposes with WSDOT because IRS and FARs regulations are different.

This computed rate is normally applied to direct labor, ultimately to be recovered against the agreement.

FARs Part 31 lists approximately 52 cost categories including direct and indirect costs, interest expense, et al. What follows is a discussion of some of those overhead costs which can and cannot be included in a firm's overhead rate and the basis.

## Words of Wisdom

Document, Document, Document — This cannot be over emphasized. If you want to recover your overhead costs to the greatest extent possible, document the costs incurred and have support showing payment for claimed expenditures.

For more detailed reading on the cost principles, we reference the reader to Chapter 26 of this guide which contains the FARs, Part 31 Cost Principles, applicable to commercial agreements.

## Development of an Overhead Schedule

As you may have guessed by now, an overhead schedule can only be developed if the firm has taken the time to segregate expenses by some logical cost grouping identified in the accounting ledgers. Expenditures in these cost groups must be segregated by direct project costs and indirect overhead costs. These costs are then summarized on a monthly, quarterly, or annual basis. On an annual basis, they might look like the example shown on the following page.

This example is typical of the costs found in many organizations and will be used as the basis for further discussion in the remainder of this chapter.

The purpose of providing a sample overhead schedule is to establish a starting point for a new consultant or subconsultant who is not familiar with developing an overhead schedule.

Consultants and subconsultants who have done business with WSDOT in the past are familiar with the required format. In addition, it makes good business sense for consultants to know each year the overhead costs for their business, not only for WSDOT agreements but any other contracts they participate in.

From our experience, there are a variety of ways consultants present overhead schedules. They are acceptable as long as they present information in a format we can use and audit. WSDOT Audit accepts overhead schedules for the latest complete fiscal year. The dollar amounts on the overhead schedule should agree with financial statements. Documents to support the overhead schedule should be available for inspection. We review the support documents for compliance with 48 CFR 31 (Code of Federal Regulations Federal Acquisition Regulations System Part 31 Contract Cost Principles and Procedures). We use other parts of 48 CFR as well but Part 31 is the primary one. In addition, certain WSDOT directives (i.e., D 13-50 Travel Expenses) are used for audit criteria.

Not all cost categories will be discussed in this chapter. The reader may be referenced to another location where the cost has been previously discussed. In some cases, we believe the title of the cost category is adequate regarding the classification of the cost item.

**Please Note:** There is a difference between the rules and regulations used by the Internal Revenue Service for tax purposes and those used for government contracting regarding the eligibility of business costs!

Sheet 1

XYZ Corporation  
Overhead Schedule  
December 31, 1998

Description	Stated Amount	Adjustments	Ref.	Audited Amount	Percent
<b>Direct Labor Base</b>	\$1,220,565	\$ 26,703	L	\$1,247,268	
<b>Overhead Costs</b>					
Vacation Leave	\$ 161,578			\$ 161,578	12.95%
Holidays	54,250			54,250	4.35
Sick Leave	24,972			24,972	2.00
Payroll Taxes	147,870			147,870	11.86
Employee Insurance	90,043			90,043	7.22
Unemployment Taxes	17,528			17,528	1.41
Worker's Comp	7,564			7,564	0.61
401(k) Plan Contributions	32,752			32,752	2.63
401(k) Plan Administration	7,246	\$ 430	B	7,676	0.62
Bonuses	300,201	(3,588)	D	296,613	23.78
Rent	142,947			142,947	11.46
Office Maintenance	17,785			17,785	1.43
Telephone	18,604	(1,232)	F	17,372	1.39
Principal's Salaries	126,130	(5,650)	B	120,480	9.66
Clerical Salaries	80,006			80,006	6.41
Administrative Salaries	391,496	(28,514)	C,L	362,982	29.10
Accounting	71,006	(5,570)	E	65,436	5.25
Business Taxes	65,386			65,386	5.24
Insurance	101,571	(7,590)	O	93,981	7.53
Warranty Service	3,035	(3,035)	N	0	0.00
Employee Recruiting	18,798	(1,350)	F,G	17,448	1.40
Printing, Stationary, Etc.	82,585	(4,490)	F,I	78,095	6.26
Computer Expenses	59,967	(52,741)	B,C	7,226	0.58
Computer Administration	41,394	(34,944)	B,C	6,450	0.52
Auto and Travel	35,749	(24,939)	B,K	10,810	0.87
Fees, Dues, Meetings, Etc.	31,186	(552)	G	30,634	2.46
Subscriptions and Publications	6,444			6,444	0.52
Professional Services	10,265	(5,276)	E,H,J	4,989	0.40
Depreciation	78,703	(59,829)	C,M	18,874	1.51
Mileage Reimbursement	(15,694)			(15,694)	-1.26
Advertising and Promotion	9,218	(9,218)	A,F	0	0.00
Bad Debts	12,007	(12,007)	A,H	0	0.00
Entertainment	3,800	(3,800)	A	0	0.00
Contributions	1,110	(1,110)	A,I	0	0.00
Federal Income Tax	66,258	(66,258)	A,E	0	0.00
Interest	7,535	(7,535)	A	0	0.00
Miscellaneous	14,876	(10,508)	A	4,368	0.35
Cost of Money	6,462			6,462	0.52
<b>Total Overhead Costs</b>	<u>\$2,332,633</u>	<u>\$(349,306)</u>		<u>\$1,983,327</u>	<u>158.98%</u>

<b>Overhead Rate</b>	190.58%	158.50%
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**References**

- A. Unallowable amounts removed by XYZ Corp. per various FARs cites.
- B. Adjusted to year end trial balance actual cost amounts.
- C. Allocation by XYZ Corp. to computer cost center.
- D. Adjustment for WSDOT Bonus Policy. Maximum allowable amount is 15% of total allowable overhead.
- E. Federal income tax return preparation over \$250 unallowable per 48 CFR 31.205(b)(1), 48 CFR 31.201-6(d), and WSDOT policy.
- F. Advertising and public relations costs unallowable per 48 CFR 31.205-1(d).
- G. Costs of alcoholic beverages unallowable per 48 CFR 31.205-51.
- H. Bad debts unallowable per 48 CFR 31.205-3.
- I. Contributions unallowable per 48 CFR 31.205-8.
- J. Organization costs unallowable per 48 CFR 31.205-27(a)(1).
- K. Travel costs in excess of Federal Travel Regulations unallowable per 48 CFR 31.205-46(a)(2)(i).
- L. Adjust labor amount for uncompensated overtime.
- M. Adjustment to XYZ Corp. capitalization policy.
- N. Direct costs on other projects unallowable in overhead per 48 CFR 31.202(a).
- O. Key man life insurance unallowable per 48 CFR 31.205-19(a)(2)(vi).

## Cost Categories Normally Included in a Firm's Overhead Schedule

Accounting — costs incurred for staff accountants or outside accounting vendors.

Administration — typically, salary costs of people not charging to any one final cost objective, such as a direct project.

Advertising and Promotion — mostly unallowable costs.

Annual Leave — vacation time paid to employees, officers, and owners.

Auto and Travel — costs for travel that are not project related. Payment of these costs must comply with the Federal Travel Regulation.

Bad Debts — losses on projects due to write offs of billed uncollected costs and/or unbilled costs. Not an allowable overhead cost.

Bonuses — incentive compensation; these costs are limited by WSDOT policy.

Business Taxes

Clerical Salaries — not charged direct to a project.

Computer Administration

Computer Expenses — net of costs recovered from direct billings.

Contributions — gifts to people or entities of money, services, assets, or any other item that may appear in the balance sheet or general ledger of a firm. Not allowable in overhead.

Depreciation

Direct Labor — dollar value of all labor worked for projects, regardless of whether billed or not.

Direct Labor Base — the total amount of direct labor recorded for all projects. The amount which is used as the base for the calculation of an overhead rate.

Employee Insurance — medical, dental, life, disability, etc.

Employee Recruiting — help wanted advertising and interview expenses. Travel costs must comply with the Federal Travel Regulation.

Entertainment — any expense which appears to be social in nature. Not allowable in overhead.

Fees, Dues, Meetings — Costs of belonging to professional organizations and societies. Cost of attending official business meetings. These costs must comply with the Federal Travel Regulation where applicable.

Holiday — all paid holidays observed by the firm.

Income Taxes — federal income taxes are unallowable in overhead. State income taxes are allowable.

Insurance — general business and liability insurance. May be paid to a vendor or set up as a bona fide self insurance fund.

Interest Expense — Costs of borrowing, regardless of how paid. Unallowable in overhead.

Mileage Reimbursement — payments to employees for using their personal vehicles for company business, net of costs recovered from direct billings to projects. Rates paid cannot exceed the current rate allowed in the Federal Travel Regulation.

Miscellaneous — any expense not included in another account.

Overhead — indirect business expenses not directly chargeable to a project.

Principals Salaries — not charged direct to a project.

Printing, Stationary — paper products not for promotional purposes.

Professional Services — general legal, accounting, management consulting, and other services.

Rent — office and storage space costs, not charged direct to a project.

Repair and Maintenance — janitorial services and minor repairs to office space and equipment.

Retirement — costs paid by the firm for retirement programs, including 401(k) plan contributions and administrative expenses. Does not include contributions made by the employees.

Sick Leave — costs paid by the firm normally associated for leave taken for illness, injury, etc.

Social Security Taxes

Subscriptions and Publications

Telephone — costs incurred not chargeable to direct projects.

Unemployment Taxes

Warranty Services — costs incurred for previously completed projects, or fees for service contracts.

Workers Compensation

## **Types of Unallowable Costs Often Included in Overhead**

The following is a listing (which is not all-inclusive) of costs which auditors typically find in a firm's overhead cost categories.

Updates to this guide may include additional examples of unallowable costs as they come to our attention.

Our recommendation to firms who may include these types of costs in their overhead computation is remove them to the extent possible before the firm is audited.

**A**

Advertising 48 CFR 31.205-1(d)

Alcoholic beverages per 48 CFR 31.205-51

**B**

Bad debt expense per 48 CFR 31.205-5(c)

Bonuses in excess of 15 percent of total allowable overhead are unallowable per WSDOT policy.

Brochures per 48 CFR 31.205-1(f)(5)

**C**

Christmas party expenses in excess of \$25 per employee per 48 CFR 31.205-14 and WSDOT policy

Christmas cards for clients and the general public per 48 CFR 31.201-4

Credits for income from work study employees 48 CFR 31.201-5 per 48 CFR 31.205-1(f)(7), 48 CFR 31.205-43(a)

Contributions per 48 CFR 31.205-8

Civic club dues, except Chamber of Commerce, per 48 CFR 31.205-1(f)(7)

Christmas gifts per 48 CFR 31.205-14

Common control rental costs per 48 CFR 31.205-36(b)(3)

Costs not identified per 48 CFR 31.201-6(c)

**D**

Depreciation in excess of amount claimed on federal tax return per 48 CFR 31.205-11

Donations per 48 CFR 31.205-8

Directory advertising per 48 CFR 31.205-1(d) & (f)(1)

Direct costs billed to clients per 48 CFR 31.202(a)

Display costs per 48 CFR 31.205-1(f)(2)(i)

**E**

Entertainment per 48 CFR 31.205-14

Expenses with no support documents disallowed per 48 CFR 31.201-6(c)

**F**

Flowers to clients per 48 CFR 31.205-13(a)

Federal income tax per 48 CFR 31.205-41(b)(1)

Federal income tax preparation fees over \$250 per year per 48 CFR 31.205-41(b)(1), 31.201-6(d), and WSDOT policy

Finance charges per 48 CFR 31.205-20



**G**

**H**

**I**

Interest per 48 CFR 31.205-20

**J**

**K**

Key man life insurance per 48 CFR 31.205-19(a)(2)(vi)

**L**

Local meals per 48 CFR 31.205-14 and WSDOT Travel Directive D 13-50, except when the meal is a bona fide business meeting. To support costs, there must be an agenda, a listing of people who attended showing how much was spent for each person.

Local lodging per WSDOT Travel Directive D 13-50

Delinquent license fee per 48 CFR 31.201-3(a)

**M**

Costs of memberships in civic and community organizations, and not a membership in trade, business, technical and professional organizations per 48 CFR 31.205-1(f)(7&8) and 48 CFR 31.205-43

**N**

**O**

**P**

Penalties per 48 CFR 31.205-15(a)

Prior year expenses per 48 CFR 31.201-2(c) and 48 CFR 31.201-3(a)

Premium time per 48 CFR 22.103-2

**Q**

**R**

Recovered in-house charges per 48 CFR 31.201-5

Recovered long distance phone calls per 48 CFR 31.201-5

Related party profit portion on rent per 48 CFR 31.205-36(b)(3)

**S**

Shareholder life insurance per 48 CFR 31.205-19(a)(2)(vi)

**T**

Trade show and advertising per 48 CFR 31.205-1(f)

Preparation fees for federal income tax returns in excess of \$250 per 48 CFR 31.205-41 and 31.201-6, and WSDOT policy

Travel costs exceeding maximum allowed per WSDOT Travel Directive D 13-50

**U**

Unsupported costs 48 CFR 31.201-6(c)

**V****W****X****Y****Z**

## **Establishment of a Direct Labor Base When Developing Overhead Rates**

During an audit, the WSDOT auditor will analyze how the firm charges labor and how it allocates costs based on the labor charges.

The objective of the analysis of the consultant's labor system is to ensure that labor costs are segregated between direct and indirect labor. This can include the identification of specific cost or profit centers, departments, contracts or cost objectives, or employees or groups of employees.

In reviewing a consultant's direct labor base, the auditor may select a period of time (usually the current fiscal year) to sample. The sample size selected is dependent on the size of firm. The auditor will then identify and list all individuals including the hours worked for direct projects and charged indirectly, including vacation, holiday, and sick leave hours.

These costs may be traced to a summary document. The document could be manually prepared or developed from a computer based system. This type of document may be identified as a labor distribution report (LDR). The auditor will compare the hours on the time sheet to the hours reported on the LDR. To make comparisons, the auditor will request a copy of the payroll registers which coincide with the time sheets and LDR amounts.

The auditor will then verify labor costs via a weekly or monthly payroll document to a general ledger transaction which identifies the dollar amount. These costs should match the dollar amount calculated by the auditor from the time sheets and/or LDR. By comparing dollar amounts in the General Ledger, the firm's direct labor, indirect labor, holiday, vacation, and sick leave costs are verified.

Based on a series of audit samples, the auditor will either accept the labor system or note deficiencies and adjust the direct labor base and/or indirect labor as necessary.

## Overhead Rate Development — General Summary

All amounts listed on an overhead schedule should agree with a general ledger, trial balance, or financial statement. Preferably the consultants' accountant or certified public accountant should have compiled, reviewed, or audited the financial statements for the latest complete fiscal year and when possible, issued a report.

### **Direct Labor**

Direct labor costs are normally the largest cost item listed on the overhead schedule. Direct labor should be listed separately on the overhead schedule because it is the basis for determining an allowable overhead rate. In order to verify these costs, support documents needed may include:

- general ledger
- labor distribution reports
- payroll registers
- time sheets
- W-2s
- personnel files for paid hourly rates and job classifications
- check register
- canceled checks
- journal entries
- job charge coding lists

All original support documents used to generate the direct labor amount may be requested.

### **Other Costs**

All other costs on the overhead schedule can be grouped in various ways:

- indirect
- overhead
- fringe benefits
- salary related
- general and administrative

Support documents needed here include but are not limited to:

- general ledger
- invoices
- vouchers
- agreement files

- recap of billed costs
- depreciation schedules
- tax returns
- rental agreements
- insurance policies
- bonus policy
- travel expenses
- check register
- cash disbursement journals
- canceled checks
- journal entries
- job charge coding lists

### ***Indirect Labor***

Indirect labor would include the same kind of support documents as direct labor:

- general ledger
- labor distribution reports
- payroll registers
- time sheets

### ***Office and Administrative Costs***

Office costs and other in-house costs for reproduction, computer time, word processing, equipment rental, etc., can be stated so much per copy or so much per hour. Documents used to calculate the per copy or per hour charge would be necessary to determine the source of the per copy or per hour charge. Again, all support documents used to generate amounts on the overhead schedule would be needed. See Chapter 13 for more information.

All costs are subject to tests of allowability, allocability, and reasonableness based on federal, state and WSDOT laws, rules regulations, and policies.

### ***WSDOT Overhead Policy***

The WSDOT Overhead Policy was issued in 1994. It is included here for your use.

Cost Category	WSDOT Policy (Overhead Costs)
Athletic Club Membership	Allowable, if costs are reasonable (maximum \$40 @ month @ employee using club) and memberships are available to all of the consultant's employees.
Bank Fees	Allowable; unless the fee is for interest or penalties.
Candy	Allowable per employee morale costs, if the costs are not excessive when compared to industry standards.
Cookies	Allowable per employee morale costs, if the costs are not excessive when compared to industry standards.
Coffee	Allowable per employee morale costs, if the costs are not excessive when compared to industry standards.
Chamber of Commerce Dues	Allowable; these are business organizations.
Christmas Cards	Allowable for employees and their families only. Unallowable for clients, etc.
Christmas Parties	Allowable, if reasonable. Allow up to \$25 per attending employee, however, must exclude alcoholic beverage costs.
Donuts	Allowable per employee morale costs, if the costs are not excessive when compared to industry standards.
Federal Income Tax Preparation	Allowable up to \$250 per year.
Flowers	Allowable per employee morale costs, if the costs are not excessive when compared to industry standards.
Greeting Cards	Not allowable. This is an advertising cost.
Lunches	(Incurred during nontravel status) Allowable at a bona fide business meeting and if the following documentation is provided: <ol style="list-style-type: none"> <li>1. Date and location of meeting.</li> <li>2. Names of attendees.</li> <li>3. Purpose of the meeting.</li> <li>4. Cost of meeting, by item.</li> </ol> <p><b>Note:</b> The allowable amount per person cannot exceed the WSDOT Travel Directive D 13-50 amount for the meal period.</p>
Subsistence/Lodging Costs	Consultant is not subject to the maximum lodging, or subsistence amount as outlined in WSDOT Directive D 13-50 in overhead (this can include incidentals, tips, transportation to meals, etc.). They are subject only to the total per diem cost limitations.
Summer Picnics	Allowable, if reasonable. Allow up to \$10 per attending employee. However, must exclude alcoholic beverage costs.